
EXHIBIT 9.3E
CASE STUDY OF FBC SERVICES

Sinkhole Ltd., is a CFC located in Panama. It provides a network of mud engineers and well supervisors to expatriate oil companies, a service also provided by its parent Wells R Us. The stock of Wells R Us is owned by one shareholder and his spouse, who act as joint officers of both Sinkhole and Wells R Us. Sinkhole pays Wells R Us a management fee, which covers various services provided by the parent. The consultants, mud engineers and supervisors, are independent contractors.

The payments to the consultants equals 60 percent of the cost of the contracts. The cost of the Wells R Us' services (in the form of management fees) is less than 50 percent of Sinkhole's total costs. If this were the only test to be applied, the Wells R Us' services would not constitute substantial assistance.

However, whether or not the Wells R Us services gave Sinkhole the skills which were a principle element in producing the income from the Sinkhole contracts must be determined. Understandably this will be the area in which the taxpayer and the auditor will not agree. The argument centers around the question of what constitutes a principle element in producing Sinkhole's income.

One has to look at each of the contracts and consider what the oil companies (the clients) are buying. In return for the payment of a daily rate, reimbursement of travel and living expenses, payment and absorption of a particular country's taxes by the oil companies (the client's), those oil companies expected Sinkhole to provide: engineers or other technicians as needed that were fully qualified; to make the travel arrangements for the consultants; to arrange their work schedules to meet the needs of the oil companies; and to provide workmen's compensation for the consultants.

Assume that according to the agreements, the technicians (consultants) are expected to perform services at the direction of, and under the supervision of, the oil companies. Assume also that Sinkhole has no right or obligation to supervise the daily performance of the consultants. The oil companies relied on Sinkhole's ability to provide them with a cadre of qualified consultants, and the success of obtaining a job depended on how fast a consultant could be supplied.

So what skills were needed of Sinkhole to fulfill its contracts and produce its income? In order to provide enough consultants that were qualified, someone had to recruit them, understand what qualifications were needed, collect feedback from the client to that effect, and maintain a list or network of the consultants. Someone had to schedule the jobs, make travel arrangements, notify the consultants of the jobs, pay the consultants,

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collect the fees, and provide insurance coverage. Someone had to administer the contracts, prepare bids, negotiate contracts, execute and arbitrate disputes. Someone had to monitor potential sources of new jobs and advertise. These were the skills that were needed and who provided those skills and services? The determination of who provided the actual services is paramount to the issue.

After reviewing all of the CFC's contracts, telex files and correspondences surrounding the contracts, it was determined that all of these functions were performed by Wells R Us employees. The employees of Sinkhole were only the two officers that were joint officers of both corporations and the activities of the joint officers should be presumed to be services rendered by Wells R Us on behalf of Sinkhole.^{Note1}

Therefore, the auditor's position is that the assistance furnished to Sinkhole from Wells R Us is substantial assistance within the meaning of the regulations and that same assistance furnished to Sinkhole assists the company directly in the performance of its contracts within the meaning of the regulations. Below are the results of the functional analysis:

FUNCTION	WELLS R US	SINKHOLE
A) Prepared Bids and Estimates	X	
B) Assumed Financial Responsibility	X	
C) Administrative Duties	X	X
D) Paid Contractors	X	
E) Marketing and Sales Promotion	X	
F) Negotiation of Contracts	X	
G) Executed Contracts	X	
H) Obtained Insurance Coverage	X	

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I) Made Travel Arrangements	X	
J) Obtained Permits and Visas	X	
K) Invoicing and Follow-up	X	
L) Job Scheduling	X	
M) Sending Resumes	X	
N) Contract Dispute Arbitration	X	
O) Operation Monitoring	X	
P) Provision of Contractors	X	
Q) Making Living Arrangements	X	X

There are some important points to remember about substantial assistance. Individual elements of assistance rendered by the related person to the CFC may not, in themselves, be considered substantial. They may, nevertheless, constitute substantial assistance when taken together or in combination with other assistance furnished by the related person.

Note 2

You will find that many situations can lend themselves to a number of international issues which can be raised in combination with, alternatively, or as inconsistent positions to each other. It is common practice of the IRS to raise a primary position along with supporting alternative positions for a particular fact pattern to protect government revenue. This is especially true in the case of FBCServices. The TR require that IRC §482 be applied first to the transaction where appropriate. This means if a CFC earns FBCServices, and any part of that income should be allocated pursuant to IRC §482, the adjustments must be made first, then the balance of the CFC's income can be treated as FBCServices.

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The example cited above was taken from an actual IRS case. In this case the examiner's primary issue was to make an allocation of 75 percent of the CFC's income to the United States parent pursuant to IRC §482. The argument was that Wells R Us was the true earner of the income because of the functions performed. Another argument that could have evolved related to the value of services provided to the CFC from the parent, but no economist was available. The IRS International Examiner relied on Hospital Corporation of America, 81 TC 520, for this position.

There were two reasons for making the IRC §482 issue the primary issue. The TR requires that the FBCServices be determined after any appropriate IRC §482 adjustments are made. Also, by making a IRC §482 adjustment, the parent corporation could not avail itself of the deemed foreign tax credit pursuant to IRC §960.

The secondary issue raised was to treat the balance of the CFC's earnings as FBCServices. The alternative position was to treat the entire earnings as FBCServices, and a weaker, alternative issue was to "sham" the CFC and attribute the income to the parent corporation pursuant to IRC §61. Finally, an inconsistent issue was raised to require a federal Form 1120F from the CFC, arguing that the CFC earned income that was effectively connected with a trade or business conducted in the United States. The purpose for providing the options was to provide the IRS Appeals and Legal Divisions some flexibility with the assessment. IRS Appeals Officers may not raise alternative issues. Therefore, any substantive arguments must be made in the examination report.

FINAL NOTE: It is significant to point out that the IRS auditor will make the effort to evaluate alternative positions so that as the case proceeds through IRS Appeals and Legal Divisions the positions are laid out. As a result, the IRS Appeals Officer or attorney may not be as likely to withdraw the issue. Considering that the taxpayer, for California purposes, now also has settlement opportunities, the field auditor should consider doing the same.

1. General Counsel Memorandum 38065. Technical Advice Memorandum, Letter 8127017, March 26, 1981.

2. TR §1.954-4(b)(2)(ii)(d).